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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967.

No. 871

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OKLAHOMA,
Petitioner,

vs.

RALPH E. BARBY AND MARIE BARBY,
Respondents.

PETITION FOR REHEARING OF DECISION RENDERED MARCH 11, 1968

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PETITION FOR REHEARING

NOW COME the Petitioners, RALPH E. BARBY and MARIE BARBY, and by their counsel, and respectfully pray for a rehearing of this case before a full bench. This Petition is made because Petitioners believe the case of *Commissioner of Internal Revenue* v. *P. G. Lake, Inc.*, 356 U.S. 260, upon which the Court premised its decision, is clearly distinguishable and does not apply to the facts or law governing this proceeding.

1. In the five cases involved in *Commissioner* v. *P. G. Lake, Inc.*, supra, each of the taxpayers created or carved out a portion of their greater mineral interest in producing

properties, specifically for a direct sale or exchange for money or other property. They then disposed of such smaller interests, reserving in themselves the residuum.

In each instance, there was current production in amounts reasonably estimated to pay out such carved out payments within a short period of time, and such payouts did, in fact, occur.

This Court, we agree, in a lucid opinion by Mr. Justice Douglas (who, we note, would deny the writ of certiorari in this case), correctly treated such proceeds as assignments of future income under the reasoning of *Helvering* v. *Shaffner*, 312 U.S. 579, *Helvering* v. *Clifford*, 309 U.S. 331, and *Helvering* v. *Horst*, 311 U.S. 112, under the particular facts there involved.

We respectfully and earnestly submit, however, that the case of *Commissioner* v. *P. G. Lake, Inc.*, supra, is wholly inapplicable to the case at bar, both in facts and in law, for the following reasons:

A. In *Commissioner* v. *P. G. Lake, Inc.*, supra, each taxpayer carved out of a presently owned producing mineral interest a specific production payment interest for a sale or exchange to a specific assignee, reserving to themselves the remaining mineral interest.

B. In the instant case, there are three distinct and separate transactions involved. In the first transaction, respondents reserved from an oil and gas lease to Cabot Carbon Company (1) the usual landowner's royalty interest of one-eighth, and (2) out of the lessee's normal seven-eighths interest, "90% of all oil, gas and other hydrocarbons in and under and that may be produced and saved from" the lands then leased until they had received $300,000.00, plus interest at the rate of 5 1/2% per annum. (R. 27). Neither of said interests so reserved were dependent upon,

carved out of, or affected by the other. *Wiseman* v. *Barby*, 380 F.2d 121.

Respondents, in said leasing transaction, therefore, were initially the recipients, and not the purveyors, of a production payment out of the lessee's normal seven-eighths interest. Upon payout of said production payment, if, as and when it occurred, the reversion would not come to respondents, as it did to the taxpayers involved in each of the cases in *Commissioner* v. *P. G. Lake, Inc.*, supra, but to the lessee, Cabot Carbon Company. Respondents' interest therein, instead of being restored upon payout of the production payment, as in the *Lake* cases, would have been completely extinguished.

After said leasing transaction was completed, and respondents became the holders of said production payment, they entered into a second transaction, i.e., an outright sale of an undivided one-half interest in said production payment in an arms length transaction, to a disinterested third party, Eby, Inc. (R. 109, Par. 19).

Then, still later, respondents entered into a third transaction, i.e., an outright sale of the remaining undivided one-half interest in said production payment, in an arms length transaction, to yet another disinterested party, Tokay Oil Company. (R. 109, Par. 19).

C. Respondents, therefore, at the time of sale, were the owners and holders of a production payment interest "* * * a property distinct and separate from the royalty interest, and a property in which taxpayers retained no reversionary interest * * *", as stated by Judge Pickett in *Wiseman* v. *Barby*, supra, which constituted an "economic interest in the oil, in place", *Palmer* v. *Bender*, 287 U.S. 551, 557, constituting a share "in the oil in the ground" which "was a reservoir of capital investment of the several

parties" (Ibid, 557); a capital asset held for more than six months, as defined by Sections 614 and 1221, Internal Revenue Code of 1954, 26 U.S.C, 1964 Ed., Sec. 614, 1221. (Respondents' Brief in Opposition, pp. 6-21 incl.).

Respondents' conveyances, then, of their entire interest in said production payments bring this case clearly within the holding of this Court in *Blair* v. *Comm.*, 300 U.S. 5, rather than that of *Helvering* v. *Shaffner*, supra, *Helvering* v. *Clifford*, supra, or *Helvering* v. *Horst*, supra.

Here, as the taxpayer had in *Blair* v. *Comm.*, supra, where he had conveyed fractional interests of his entire life estate in a trust, respondents similarly conveyed fractional interests in their total interest in the production payment involved. Just as this Court in *Blair* v. *Comm.*, supra, distinguished its decisions from *Lucas* v. *Earl*, 281 U.S. 111, and *Burnet* v. *Leininger*, 285 U.S. 136 (where the respective taxpayers had attempted to assign future salaries and fees or future partnership income), by holding that the income from the equitable interest assigned by Blair of his lifetime interest constituted an equitable interest in the corpus of the property, thus followed the owner of the property; so here, respondents conveyed their total interest in said production payment property from which future income was to be derived by their assignees, who became not only the owners immediately of such production payment, but also of all the income thereafter received therefrom.

Mr. Justice Douglas, in *Commissioner* v. *P. G. Lake, Inc.*, supra, pointed out that "only a fraction of the oil or sulphur rights were transferred, the balance being retained," and called attention at that point (by footnote No. 5) to I. T. 4003, 1950 Cum. Bul. 10, 11, which contained the following specific exception to the rule announced in

said ruling, holding that receipts from all oil payments constituted ordinary income:

> "Notwithstanding the foregoing, G.C.M. 24,849, supra, and I.T. 3895, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property, or a fraction extending over the entire life of the property."

In *Commissioner* v. *P. G. Lake, Inc.*, supra, the taxpayers simply temporarily assigned a portion of their future income from the mineral property, out of which they carved the oil assignments. Here, respondents conveyed their entire interest in said production payment, thus clearly falling within the exception to ordinary income treatment pointed out by Mr. Justice Douglas under said footnote No. 5 to said opinion. The proceeds received from said sales were not, therefore, assignments of future income, but consideration received for the entire asset conveyed, and thus taxable as capital gains.

We submit, that for the aforesaid reasons, the case of *Commissioner* v. *P. G. Lake, Inc.*, supra, is not controlling of the facts or law of the instant case, and that this Court should grant a rehearing in this proceeding in order that petitioners may clearly so demonstrate.

2. The Congress, though cognizant of attempts of the Treasury Department to treat the assignment of oil payments as ordinary income, has refused to change the law applicable thereto. During the period prior to the Second Session of the 84th Congress of the United States, the Treasury Department had, in the following cases, attempted to assess a tax upon the premise that the assignment of carved out oil payments constituted the assignment of future income taxable as ordinary income, and not under the capital gain provisions:

Hawn v. *Comm. of Internal Revenue*, 23 T.C. 516, Decided 12-23-54, later reversed (C.A. 5) 231 F.2d 340.

Caldwell v. *Campbell*, (C.A. 5) 218 F.2d 567, Decided 1/12/55.

P. G. Lake, Inc. v. *Comm. of Internal Revenue*, 24 T.C. 1016; Decided 9-20-55.

W. F. Weed, Individual, and Estate of Eleanor M. Weed, deceased, W. F. Weed, Executor, v. *Comm. of Internal Revenue*, 24 T.C. 1025, Decided 9-22-55.

Wm. Fleming and Bessie M. Fleming, husband and wife, v. *Comm. of Internal Revenue*, 24 T.C. 818, Decided 7-25-55.

John Wrather and Nell Wrather, husband and wife, v. *Comm. of Internal Revenue*, T.C. Memo Dec. —Dkt. No. 38267, Decided 4-26-55.

Dennis M. O'Connor, et al. v. *Frank Scofield, former Collector of Internal Revenue*, (W. D. Tex.) 143 F. Supp. 240, Decided 3-28-56.

In each of said cases, the lower courts had held to the contrary and treated such sales as subject to the capital gain provisions.

H. R. 9559 was introduced in said 84th Congress, Second Session. In said bill, several new sections, most of which were recommended by the Tax Section of the American Bar Association, as attested by the testimony of the Section Chairman contained in pages 197-260, inclusive, and particularly at pages 243-246 and pages 256-260 of Hearings before a Subcommittee of the Committee on Ways and Means, House of Representatives on Technical Amendments to the Internal Revenue Code, Eighty-Fourth Congress, Second Session, would have been added to the Internal Revenue Code of 1954. A proposed new section 633 governing the sale or gift of oil or production payments carved

out of a larger property would have treated the income therefrom as ordinary income, subject to a depletion allowance. Section 1221 (defining a capital asset) would have been amended by adding thereto an exception from the definition of a capital asset of "an oil, gas or production payment described in Section 633." Section 1231 (relating to the definition of property used in a trade or business) would have been amended by excluding an oil, gas or production payment described in Section 633.

Merten's Law of Federal Income Taxation, at p. 261, in note 40, reports as follows:

> "In connection with the Technical Amendments Bill of 1957, the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee published a list of unintended benefits and hardships which it intended to study. First on this list were oil and other mineral production payments, as to which the following comment was made:
>
> "A practice has developed under which the owners of oil or mineral properties sometimes carve out and sell a portion of their future right to oil or other mineral production, such as the right to receive the first $50,000 realized from the production of oil, or the right to receive the first 10,000 barrels of oil. Recent court decisions have held that the sale of a production payment carved out of any interest which the taxpayer has in an oil well is eligible for capital gain treatment. Also, it has been held that a taxpayer who gave a mineral payment to a charity was entitled to a charitable deduction for the value of the payment and at the same time could exclude the mineral income from his taxable income.
>
> "It is suggested that the proceeds received from the sale of oil and other mineral production payments by persons who carve them out of larger interests be treated as ordinary income from the production of

minerals. In the case of donations of carved-out production payments, adjustments would be made to prevent double benefits; that is, the benefit both of an exclusion from income and a charitable deduction.

"It is suggested that the subcommittee may also want to examine various other arrangements by which interests in oil and other mineral production are sold, such as cases where the production payments are sold after the taxpayer has previously disposed of operating interests in mineral production."

None of said proposed amendments, neither by the 84th or the 85th Sessions, were ever adopted by the Congress. The only legislative change with reference to the treatment of oil payments of which counsel is aware, is that contained in Section 543 (a) (3), Section 543 (b) (2) B, and Section 543 (b) (4), all related to personal holding company income. (26 U.S.C., 1964 Ed., Sec. 543).

The reason for such change was clearly stated in Senate Report No. 830, Part 2, 88th Congress, Second Session, where at page 250, appears the following:

"* * * an amendment has been added to section 543 (b) (4) to specifically include production payments and overriding royalties as mineral, oil and gas royalties for purposes of classification as personal holding company income under section 543 (a).

"The Treasury regulations interpreting section 543 (a) (8) of existing law currently define the term 'mineral, oil, or gas royalties' as including production payments and overriding royalties. (See Reg. Sec. 1, 543-1 (b) (11) (ii).) However, it has been brought to the attention of your committee that this interpretation of existing section 543 (a) (8) is disputed by some taxpayers. Your committee's amendment would make it clear that production payments and overriding royalties are to be treated as mineral, oil, and gas royalties under proposed section 543 (b) (4).

This amendment is not intended to affect any case involving interpretations of section 543 (a) (8) of existing law."

Said amendment was apparently in response to the case of *U. S.* v. *525 Company*, (5 Cir.) 342 F.2d 759, decided March 22, 1965, which held void a Treasury Regulation under Section 543 (a) (8), of the prior act that attempted to include income from the sale of oil payments as mineral oil and gas royalties.

Whereas, Congress has seen fit to make the above described amendment, limited only to personal holding company income, it has never adopted the proposed changes recommended by the House Ways and Means Committee of defining oil payments and overriding royalties as an exclusion to the definition of capital assets contained in Section 1221 of the Internal Revenue Code, or in an exclusion to the definition of property used in a trade or business in Section 1231, Internal Revenue Code, nor has it added any provision which would tax the proceeds from oil, gas or production payments as ordinary income as was proposed by the House Ways and Means Committee in such two consecutive sessions of Congress.

In view of such pointed refusal of the Congress to adopt the policy of the Treasury Department to tax the proceeds from the sale of production payments as ordinary income, we respectfully suggest that this Court does not propose to do that which Congress itself has refused to do.

As a matter of fact, this Court in *Cary* v. *Donohue*, 240 U.S. 430, in respect to preferential transfers in bankruptcy cases, states:

"We cannot but regard the action of Congress as a deliberate refusal to conform the requirement of Sec-

tion 60 to those of Section 3 b, and we are not at liberty to supply by construction what Congress has clearly shown its intention to omit."

In *Western Union Telegraph Co.* v. *Lenroot*, 323 U.S. 490, on the construction of child labor laws, this Court stated:

> "It is admitted that it is beyond the judicial power of innovation to supply a direct prohibition by construction. We think we should not try to reach the same result by a series of interpretations so far-fetched and forced as to bring into question the candor of Congress, as well as the integrity of the interpretative process. * * * To translate this act by a process of interpretation into an equivalent of the bills Congress rejected is, we think, beyond the fair range of interpretation."

In *Helvering* v. *Wood*, 309 U.S. 344, involving whether income from an irrevocable short term trust should be taxed to the grantor-trustee, under Sec. 166 of the Revenue Act of 1934, 48 Stat. 680, 686, 729, 26 U.S.C.A., Par. 166, Mr. Justice Douglas stated, with respect to the province of the Court, as follows:

> "And so far as Sec. 166 is concerned, no apparent or lurking ambiguity require or permits us to divine a broader purpose than that expressed. The legislative history corroborates this conclusion. When the 1934 Act was before the House Committee, the Treasury recommended that income from short term trusts and from revocable trusts be taxable to the creator. The Congress adopted the latter by an appropriate amendment to Sec. 166; but it did not select the former for special treatment. When such clear choice of ideas has been made in the drafting of a specific provision of the law, its language must be taken at face value. Sec. 166 is therefore not applicable to this trust since respondent is given no power to recall the corpus. * * *"

CONCLUSION

By reason of the foregoing, the petition for rehearing should be granted, in order that this case may receive the full consideration that justice requires.

Respectfully submitted,

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CERTIFICATE OF COUNSEL

I HEREBY CERTIFY that the foregoing petition for rehearing is presented in good faith and not for purposes of delay.

.....

JOHN K. SPECK